

Focus On Meaningful Indemnity Language In Tech Licenses

Law360, New York (September 20, 2013, 12:01 PM ET) -- Company ABC has just received a letter seeking indemnity from its customer based on software or hardware it provided to the customer for \$15,000. The indemnity request is based on a letter the customer received from a nonpracticing entity alleging the customer infringes the NPE's patent based on the ABC software or hardware.

One big problem: The patent troll seeks amounts in excess of \$100 million based on the customer's revenues from use of the software or hardware, and the customer says ABC company is obligated under its indemnity clause not only to defend the case but to pay any resulting damages based on the customer's revenues. Suddenly a boilerplate indemnity clause that no one focused on has become the most important clause in the contract and threatens liability bearing no relationship to the size of the contract. Sadly, this is a common story.

Indemnity clauses are often one of the last "boilerplate" provisions incorporated into a software license or hardware supply agreement. Many times these provisions are not negotiated at all, or are simply borrowed from "similar" agreements involving "similar" transactions. Yet indemnification provisions — clauses that allocate risk between the supplier and customer — shift large amounts of financial responsibility that can end up dwarfing both the original contract amount and even the entire net worth of a contracting party. Indemnity provisions can also contain clauses that in particular circumstances may render the indemnity clause worthless as a practical matter. That can be good or bad depending on which party you are, but in many cases that result is unexpected.

Unfortunately, parties to an indemnity obligation often find themselves learning and arguing the meaning and impact of their indemnity clauses for the first time after it is too late, and after the financial consequences have already begun. Counsel to the parties are left to explain how an indemnity clause that seemed so innocuous at the time of contracting now has such dramatic and unanticipated consequences. Moreover, there is little interpretive case law on indemnity provisions because indemnity arguments are often made and resolved informally or without public court resolution. Rarely do potentially liable parties such as indemnitees and indemnitors wish to air their legal differences in a public forum or in view of the third-party claimant.

While this article does not attempt to cover all the important aspects of indemnity provisions, there are several key clauses in indemnity provisions that are commonly outcome determinative and are most likely to become major negotiation items in an indemnity discussion. Often the third-party cases for which indemnity is sought settle, and thus these original negotiations effectively determine which party bears responsibility for the litigation costs and settlement. Or, if the plaintiff obtains an adverse judgment, these clauses ultimately determine the allocation of liability. The following are several key clauses to be aware of when reviewing indemnity provisions:

When Does the Indemnity Obligation Accrue?

Indemnity provisions use different language to describe when the obligation arises. Very subtle differences in language can have widely divergent meaning. For example, an indemnity provision may provide an obligation to defend and indemnify for “any allegation of infringement,” a “claim of infringement,” a “judgment of infringement,” or simply “infringement” by the indemnitor’s product. Each of these clauses can be argued to have different meanings, depending on the context. An “allegation of infringement,” if properly pled against the indemnitor’s product, can accrue as soon as a letter alleging infringement is received.

A “claim of infringement” may not accrue until a complaint is filed. Indemnity for a “judgment of infringement,” one can argue, means that the defense obligation is triggered only if and after the indemnitee loses the case. And accrual upon “infringement” could be argued to have any of the meanings above, depending on the context. For example, an indemnitor could take the position that its product simply does not infringe. Thus, a claim merely alleging infringement, if believed to be baseless or frivolous, could be argued to be insufficient to trigger an obligation to indemnify for actual “infringement.”

Similarly, when coverage accrues can depend upon how the indemnitor’s product is referenced in the indemnity provision. Does the provision state that it covers an allegation against the indemnitor’s “XYZ product”? Or does it state that it covers any allegation against the customer system in which the indemnitor’s product is employed?

Often it is hard to tell from an initial patent complaint, for example, exactly which components in an accused system (and particularly in a distributed computer system) are alleged to infringe. The complaint may name the customer’s system as the accused product, but may not discern among its particular subparts. Thus, a potential indemnitor can take the position that, until the party requesting indemnity can adduce more particularized allegations from the plaintiff (such as detailed infringement contentions) stating that the indemnitor’s “XYZ product” is the infringing component, then no indemnity obligation has arisen.

These differences in language can dramatically impact the negotiating posture between the parties at the outset under an indemnity provision. And depending on whether a party wishes to control the defense of a claim, that party may wish to take a different position on the meaning of the same language in different contexts.

What Types of Infringement and Damages Are Covered?

Many indemnity provisions commonly include a carveout clause that exempts liability for, among other things: (a) the combination of a supplier’s product with other products or services; (b) the modification of a supplier’s product; or (c) unauthorized use of the supplier’s product. Again, small differences in language can be of great importance. For example, does the carve-out clause exempt liability for any combination or modification of the supplier’s product? Or does it only exempt claims either: (i) “based on” the modification or combination; or (ii) that would not exist “but for” the modification or combination?

These differences in language can make a dramatic difference, not only for determining when a defense obligation accrues but also for allocating ultimate responsibility. Moreover, it’s often difficult to tell whether a supplier’s product is accused on its own or in combination with other components in an accused system. In some cases, this may not be determined until after a claim construction or even an infringement finding. And even if a clause exempts infringement through “combination,” does the supplier’s product nonetheless trigger an indemnity obligation if the product contributorily infringes (i.e., the product has no noninfringing use other than in the accused combination)? The precise language

used in the indemnity provision matters.

It is also important to note whether an indemnity clause just covers damages awarded against the indemnified party due to claims, suits or allegations, or whether it also covers other “damages” or “losses” to the indemnified party generally. If the latter, an indemnitee can seek to recover not only its liability to any third-party but also potentially its lost business resulting from any alleged infringement. A separate warranty of noninfringement can lead to the same result.

Who Controls the Defense?

An important part of any indemnity provision is the language concerning which party controls the defense of the case, the selection of counsel, and approval of any settlement. For example, does the party controlling the defense require the other party’s permission to settle the case? If so, is such approval a matter of absolute discretion or may approval “not be unreasonably withheld”? Small details like this can dramatically impact which party really controls the defense and resolution of the third-party claim.

Of particular importance are clauses that require that an indemnitor be provided “sole control of the defense” of a claim. Often such clauses are no cause for dispute, and simply allocate control of the claim to the party that will ultimately bear responsibility. But in some cases a “sole control” clause can render the indemnity provision useless to the indemnitee.

For example, what if the party to be indemnified is a large public corporation with massive potential liability on the claim and the indemnifying supplier is a small company with limited resources to pay any judgment? Can the large public company realistically turn over complete control of its defense? Or what if the indemnifying party has a contractual liability limit that is only a small percentage of the potential claim? Can the party seeking indemnity realistically give over complete control of the defense in those circumstances? The answer may be no, and the indemnitor can essentially avoid its obligation by aggressively asserting the “sole control” requirement.

Similarly, a party seeking indemnity may have multiple suppliers with products that are implicated in a third-party infringement suit for which it may seek indemnity. If two or more suppliers have “sole control of defense” clauses, can the indemnitee possibly turn over “sole” control of the defense to two different suppliers? Even if only one supplier has a “sole control of defense” requirement, can that supplier realistically be granted sole control to defend allegations against other supplier’s products? For all these reasons, a “sole control of defense” clause should not be overlooked, particularly in a multi-supplier environment, where the parties have disparate financial capabilities, or where the indemnifying party has low liability thresholds.

What Are the Liability Limitations?

The importance of liability limits may seem obvious, but the practical impact of liability limits on indemnity provisions is sometimes overlooked. Limitations of liability provisions are generally stated in separate sections of a contract than the indemnity provisions. Sometimes liability limitations provisions address indemnity obligations specifically, sometimes they do not.

Often the liability limits in a contract are developed with reference to the particular product(s) or service(s) supplied, and may for example limit the supplier’s liability to the total amounts received by the supplier under the contract. Such a provision may be appropriately tailored to many types of potential claims, but may need to be thought through with respect to its impact on indemnity claims that may be based on the customer’s liability.

Limitations provisions may also exempt liability for “lost profits,” or for “consequential” or other types

of damages. If such limitations apply to indemnity claims, the parties may need to consider how those limitations will apply in practice. Finally, if a contract provides both a warranty of noninfringement and an indemnification for infringement claims, the liability limitations for both should be consistent.

Conclusion

The above are just some of the important clauses in indemnity provisions, but they are often overlooked during drafting. They commonly are among the most important clauses in an indemnity negotiation once a third-party claim is asserted. Parties involved in negotiating such provisions both at the outset and once a third-party claim is asserted should look very carefully at the specific language used in these clauses.

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